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Economic Policy Coordination and the Dollar September 1989

Background: The growing integration of the world economy and globalization of financial markets have heightened recognition of the interdependence of nations and the need for close cooperation. Beginning in 1974, the heads of state or government of the seven largest industrial countries (the US, Japan, West Germany, France, the UK, Italy, and Canada) have met in annual economic summits to consider issues of common concern and to develop cooperative approaches. Since 1985, more formal arrangements for the coordination of economic policies have been developed. The finance ministers and central bank governors of the US, Japan, West Germany, France, and the UK met in 1985, and in 1986 their Canadian and Italian counterparts joined them in regular meetings of what became known as the Group of Seven (G-7). The G-7 meetings are designed to foster more consistent and compatible economic policies and performance among the participants to achieve shared objectives of sustained global growth with low inflation, reduced trade imbalances, and greater exchange market stability.

1982-85: The divergence of economic policies and performance among the major industrial countries from 1982 to 1985 led to a sharp rise in the dollar and the emergence of substantial trade imbalances. Over this period, the US current account position went from rough balance to a deficit of more than $100 billion, with faster growth in the US than in most other major countries contributing to this outcome.

Plaza Accord: In September 1985, then-Treasury Secretary Baker and his counterparts from Japan, Germany, the UK, and France met as the Group of Five (G-5) at the Plaza Hotel in New York. They agreed on coordinated economic and exchange rate policies to reduce global trade imbalances and to achieve currency values more in line with economic fundamentals, including a depreciation of the dollar. The apparent success of the Plaza Accord suggested that coordination among the largest economies can help spur adjustment in the international economy and its fast-moving currency markets.

Milestones in the coordination process: The coordination process has developed gradually in recent years and is now an accepted feature of the international economic landscape. President Bush reaffirmed his commitment to it within weeks of the inauguration when Treasury Secretary Brady hosted a G-7 meeting in February 1989.

Among its milestones are:

- Tokyo summit (May 1986): Agreement was reached to establish a formal process linked to the annual economic summits for coordinating economic policies, including the use of economic indicators to assess the consistency of policies. The G-7 was formed to conduct the coordination effort, with the Managing Director of the IMF invited to participate.

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- Louvre Accord (February 1987): Specific economic policy commitments were agreed to improve global growth and reduce trade imbalances. It also was agreed that the substantial exchange rate changes achieved following the Plaza Accord had brought currencies within ranges broadly consistent with economic fundamentals and that the group would cooperate closely to foster stability of exchange rates.

- Venice summit (June 1987): This 13th summit endorsed measures to refine the coordination process, including the adoption of medium-term objectives and short-term performance indicators to assess the consistency of policies and the possible need for remedial actions.

- December 1987 statement: Following the stock market crash of October 1987, the G-7 agreed on coordinated monetary and fiscal measures to sustain global growth, foster external adjustments, and increase exchange market stability.

- April 1988 statement: The G-7 countries agreed to develop, for inclusion in the set of existing indicators of macroeconomic performance, a commodity price indicator as an additional analytical instrument for use in the international process of policy coordination. For the third time after the Louvre Accord, the G-7 countries affirmed "their common interest in stable exchange rates among their currencies."

1988-89: The June 1988 Toronto summit, the G-7 declaration at the September 1988 International Monetary Fund (IMF) and World Bank annual meetings in Berlin, and the July 1989 Paris economic summit renewed calls on countries with fiscal and current-account deficits to take action to reduce those deficits, while countries with external surpluses were urged to pursue policies conducive to noninflationary growth of domestic demand. Discussions of possible additional actions to strengthen the coordination effort will undoubtedly continue in conjunction with the annual meetings of the IMF and World Bank scheduled for September 26-28, 1989, in Washington, D.C.

Current situation: Economic growth in the major industrial countries in 1988 and the first half of 1989 was greater than generally forecasted. Exchange rate adjustments since the Plaza Accord and shifts in the composition of G-7 economic growth have reduced the large imbalances in some major countries, particularly in the US trade deficit. Inflation, although up a bit on average, remained moderate and contained. There were intense but brief periods of intervention, particularly in the summers of 1988 and 1989, to limit spurts of dollar appreciation. On the whole, however, exchange markets have remained remarkably stable compared with those of earlier years.

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